BEFORE THE INSURANCE COMMISSIONER
OF THE STATE OF WASHINGTON

In the Matter of THE APPLICATION REGARDING THE CONVERSION AND ACQUISITION OF CONTROL OF PREMERA BLUE CROSS AND ITS AFFILIATES	No. G02-45 PRE-FILED RESPONSIVE TESTIMONY OF MARTIN E. STAEHLIN

I, Martin E. Staehlin, do hereby declare that the following facts are personally known to me and, if called upon to do so, I would testify to them.

1. In the pre-filed direct testimony filed by Premera, several opinions and / or conclusions contained in the reports submitted by PricewaterhouseCoopers LLP (PwC) were challenged or criticized. I reviewed the pre-filed direct testimony and reports presented by Premera and offer responsive testimony related to the reports, supplemental reports, and pre-filed direct testimony of Brian Ancell, Heyward Donigan, Audrey L. Halvorson, Brian Kinkead, Jerry Lusk, Kent S. Marquardt, and Thomas McCarthy. The arguments made in the reports and testimony are similar to or depend upon one another. Consequently, the following comments respond to the themes raised in the aggregate in Premera's presentations.

2. There have been many comments about the "rate-making" process "in the State of Washington". The process has been addressed by, at least, Ms. Halvorson, Mr. Lusk, Mr. Marquardt and Mr. McCarthy. While certain broad generalizations may be

made about rate-making, and the State of Washington has its own unique set of facts and circumstances that must be considered in the process, the development of premium rates for a company the size of Premera Blue Cross[1] is quite complex belying generalization. However, this complexity has various aspects. While it requires an actuarial discipline to keep all factors understood and accounted for in the development of rates across products and regions, there is also certain latitude, reflected in the exercise of professional judgment, in determining appropriate allocations of underlying costs and the methods by which those cost allocations will translate to premium rates. Consequently, there is not a single "rate" that lends itself to straight-forward monitoring but a multitude of rates for consideration by the regulator. For this reason, the regulatory process is limited in the exercise of oversight for the purpose of ensuring consistent rate development in all rate-making cells.[2]

3. The first example will address individual health coverage. Premera sold individual health insurance policies prior to 1998 when the shifts in the individual health care market in the State of Washington persuaded it to stop selling new policies. It continued to service and renew its existing policies. When Premera re-entered the market in 2001, its main thrust was in its subsidiary, LifeWise Health Plan of Washington. Currently, Premera is undergoing a major new product initiative, where

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[1] Premera Blue Cross describes a family of companies; refer to Chapter 2 of Exhibit "S-20".

[2] In the process of rate-making, a health plan such as Premera will group its subscribers into various rating categories. Each category could be described as a "rate cell". The easiest way to understand the potential complexity of how many rate-cells could exist is to refer to Exhibit 7.3 of the Premera Blue Cross Small Group Rate Filing Effective 5/1/2002, submitted on February 15, 2002. This page assigns factors for each "rate-cell" simply considering the factors related to age and family status (e.g., Employee or Employee plus Spouse plus Children). The use of age and family status creates 100 rate-cells on this referenced Exhibit. The introduction of additional factors such as benefit plan or area introduces additional levels of complexity. For example, if 5 area factors and 2 benefit plans are anticipated, the number of rate-cells becomes 1,000 (i.e., 100 x 5 x 2).

most of its existing products will be converted over time to a portfolio of products termed "Dimensions".[3] The expressed intent of Premera is to, over time, convert its entire product portfolio to the Dimensions platform. The timeframe was not specifically disclosed to PwC other than "as soon as reasonably possible". Since the transition began in earnest in 2003, it is likely that for the next three to four years, a significant portion of policies sold under previous product configurations and in various Premera subsidiaries will continue in-force. Without the three-year guarantee on rating assurances, the ability to monitor the rating environment in Washington (i.e., review of rate filings) will be hard-pressed to ensure "apples-to-apples" comparisons. Consequently, for this reason and others, the rating assurances given by Premera should remain in effect for at least three years. The landscape is shifting with the introduction of and conversion to Dimensions products. PwC believes it is very likely that the rating factors applicable to Dimensions products will be theoretically determined, as opposed to being determined from actual experience, as most of the first-year Dimensions lives were on large accounts specifically targeted for conversion to Dimensions. The experience of the early converters may not mirror the experience of groups that convert later in the process. As the new rates on the Dimensions platform develop, the existing rating methodologies should be left in place.

4. The second example of the interaction of rate-regulation, the rating assurances and their impact on Premera's policies and procedures relates to small group health insurance coverage. Premera sells small group health insurance in Washington through at least three vehicles: traditional Premera, MSC, a predecessor to Premera,

[3] Refer to Chapter 6 of Exhibit "S-20".

and the new Premera Dimensions platform. Premera also sells small group coverage in the states of Alaska and Oregon, and will soon sell policies in Arizona. The claims experience used to assign prospective costs in Washington will be affected by the migration to the new Dimensions products. The administrative costs allocated to small group health coverage and the associated contingency and risk charges will most likely change as the portfolio develops. The assurances being requested for three years are one part of this complex "rate matrix" governed by policies and procedures in multiple states on multiple rating platforms. It is difficult to foresee a competitive disadvantage in the assurances requested for a consistent rate-development process in the three areas discussed in the assurances granted in Washington because of the difficulty of the competitors to assess the impact of the assurances on Premera's rating process, and then specifically to determine a strategy with a definitive advantage. An assurance of consistent rating practices for three years will give a reasonable assurance to those participating in the Washington regulated marketplace that rating practices, and hence rates, will remain reasonable through the dual transition of Premera to a for-profit company and Premera's products to the Dimensions portfolio.

5. I have one specific note in response to the pre-filed direct testimony of Mr. Lusk on page 8 under "Time Period for Washington Economic Impact Assurances". Mr. Lusk states that the two-year term of the assurances has the effect of limiting rating practices and strategies for nearly three years. He further states that this is because, since most of Premera's business renews on a 12-month rating cycle, the impact of the two-year term would carry over into the third year after conversion. Although Mr. Lusk is correct in asserting that the impact will extend "into the third year after conversion", a portion of the in-force business will not be impacted until the first

renewal following conversion. Mr. Lusk is using the twelve-month renewal cycle for group health coverage in general to make an incorrect assertion concerning the appropriate impact of the length of the guarantee of the assurances.

6. In the pre-filed direct testimony of Kent S. Marquardt, a key omission exists in the section of the testimony covering pages 8 through 13. These pages overlap the sections entitled, "Conversion Rationale"; "Premera as a Public Company" and "Form A Financial Projections".

7. In the list of qualitative characteristics of a company (that provide value), the following items are noted – provides high-quality healthcare insurance products and services, builds and maintains strong provider networks, makes sound underwriting decisions, is in good standing with regulatory authorities, has effective product design and most importantly, possesses a highly satisfied customer base that believes Premera adds significant value. This list lacks one key ingredient. Is the health plan an efficient competitor? While there may be many measures of efficiency, the key component here concerns the administrative charges (including "risk and contingency") that the health plan adds to its loss ratio (e.g., 84%). Premera has not demonstrated that it is efficient. The market statistics suggest otherwise. For example, in Chapter 8 of Exhibit "S-20" PwC shows that Premera's administrative expenses average 14.3%, while more efficiently run Blue Cross Blue Shield organizations have administrative expenses averaging 12%.

8. On page 13 of his testimony, in a list of major assumptions used to develop the Form A financial projections, Mr. Marquardt lists general and administrative costs. Major assumptions should be supportable with objective data. Premera has failed to provide adequate support for inconsistencies and contradictions in

the administrative cost allocations after repeated requests by PwC for appropriate detail. In fact, the administrative cost "assumptions" have been largely unsupported in a manner that would be expected of a public company to appropriately explain the performance of its portfolio of businesses.[4]

9. On page 8 of Mr. Marquardt's testimony, the comment related to continued strain on the company's capital position when a health plan adds members should have a footnote explaining that much of Premera's growth targets administrative service contract (ASC) members that by their nature place less strain on capital. However, the ASC marketplace rewards an efficient competitor. Premera's dictated pricing strategy on ASC business is the subject of comments by various consultants. This strategy is termed a "marginal expense" approach to pricing for growth in ASC business.[5] Given the complexities involved in implementing a marginal expense pricing strategy, it would seem prudent to discuss the risks of having a majority of new members either from a product priced on a marginal expense basis (i.e., ASC) or from a new territory, (i.e., Arizona). The need for capital to replace the losses if one were an inefficient competitor seems a totally inappropriate reason to allow a company to go public.

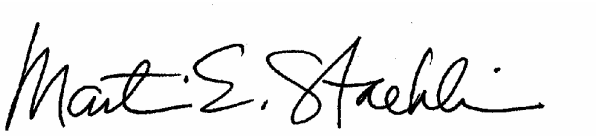
[4] Reference, page 15 of Mr. Marquardt's pre-filed direct testimony.

[5] Marginal expense pricing requires its practitioners to have a clear delineation of fixed expenses versus marginal expenses that allows one to adjust marginal expense targets as business conditions change. The theory of marginal expense pricing would charge a new client *only* the marginal expenses to cover "known" costs when adding new ASC groups, rather than also allocating a portion of fixed expenses to the cost estimates. The fixed expenses are assumed to be covered by the already existing business. Since existing business is also prone to lapse and at times exceeds the provision for risk and contingency, also included in pricing, the application of a marginal expense pricing strategy requires a sophisticated allocation of expenses to products and the ability to adjust marginal expense targets on a timely basis. These adjustments also need to flow through the pricing of the other products across which the fixed expenses are being spread.

10. A quick review of Premera's business decisions shows Premera exiting once profitable Medicaid and PEBB contracts while entering a Microsoft contract (ASC) that is losing money. Without an accurate actuarial allocation system to assess administrative costs and the performance of net income versus pricing targets, a company's ability to assess the appropriateness of its ongoing business decisions is clearly impaired.

I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

Dated April 14, 2004 at Chicago, Illinois.



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